On rescission suits in continental European company law: a functional equivalent to derivative actions?

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1. Introduction. Conventional legal scholarship has considered continental European company law to provide weaker investor protection than common law countries. Part of that weakness has been attributed to a more reluctant attitude towards, as well as (perhaps, as a consequence of that attitude) a rare use of derivative actions as a means to enforce minority shareholder protection. Recently, literature has emerged that has tried to refine conventional wisdom by pointing at an important aspect of private company law enforcement in continental Europe that previously escaped the attention of scholars. For various continental jurisdictions specifically allow shareholders to challenge company decisions through rescission suits. These suits exist next to derivative actions. In an article published in 2012, Martin GELTER coined the hypothesis that rescission suits might be functional equivalents to derivative litigation, but not without inviting further research to study its truthfulness.

This paper begins by supporting the statement that rescission suits are indeed functionally equivalent to derivative actions. By referring to the proprietary remedy following (successful) rescission suits, it is explained how they contribute to reducing agency costs and why they exist in addition to derivative actions (part A). Despite its theoretical ability to provide for an alternative to derivative actions, however, third party protection rules constrain that ability. These rules are a bar to rescission, that affects rescission suits against board decisions substantially more than suits against general meeting decisions. Therefore, it is submitted that while rescission suits are designed to reduce agency costs in general, their ability to mitigate agency costs between shareholders and directors is considerably more restricted, as a consequence of third party protection rules, than their ability to control agency costs between minority and majority shareholders (part B).

It should be noted that this paper does not intend to engage in a detailed description of enforcement via rescission suits in continental European company law. Rather, it wishes to introduce, in a most concise way, the necessary ingredients for debate, and to develop a general argument (based on a comparative analysis of the countries listed in the table in no. 5)[1]. Unless stated otherwise, the paper deals exclusively with continental European company law.

A. Rescission suits as (alternatives to) derivative litigation

2. Function: reducing agency costs… Assessing whether rescission suits are functionally equivalent to derivative actions demands that the function of rescission suits be defined: why do we have rescission suits?

[1] For the same reason, this paper does not use footnotes, but a very concise list of selected references at the end.

The logical answer to that question is that rescission suits exist to be able to control how decisions are made within a company. By making decisions challengeable through litigation, one can make sure that such decisions stay within reasonable boundaries. That doesn't exactly explain why control of the decision-making process is particularly necessary for shareholders. A look at what a company is, does.

A company needs funding, and attracts shareholders. When shareholders grow in number, (good) governance of companies becomes a public good: there is a risk of underproduction when left to every shareholder. That collective action problem is mitigated through the creation of decision-making structures: these structures, such as general meetings and boards, allow for an efficient combination of funding needs and flexible governance. They bring forth agency costs, however, in particular for minority shareholders. Controlling those agency costs is essential to attract future shareholders. And that is what rescission suits do: through an *a posteriori* control of the outcome of the aforementioned decision-making structures, they control the accumulation of agency costs. Rescission suits thus, just as derivative actions are meant to do, contribute to the reduction of agency costs.

In fact, rescission suits have a broader potential to reduce agency costs: they can be brought against decisions of the general meeting as well as the board of directors, whereas derivative actions target (appointed, *de facto* or shadow) directors. When brought against board decisions, rescission suits aim at reducing agency costs between shareholders and directors; when brought against general meeting decisions, rescission suits purport to mitigate agency costs between minority and majority shareholders (see, also, no. 8). Derivative actions intend to reduce agency costs between shareholders and directors alone.

3. …through a proprietary remedy. But, if both derivative and rescission suits contribute to reducing agency costs, the question still remains: why do we have rescission suits next to derivative actions? The answer rests on a clarification of what it is that rescission suits do, and on a concise comparison.

First, the way in which rescission suits aim to achieve a reduction of agency costs is special. They provide shareholders with a proprietary remedy. That is, when a suit is successful, the involved decision is declared null and void (i.e. 'rescinded'). The purpose of that remedy is to achieve the *status quo ante* as closely as possible: things will have to be reversed as if the wrongful decision was never taken. A successful rescission suit thus results in the restoration of everything that has been done in implementing that decision. Eg, rescission of a decision to sell off certain assets results in setting aside the selling contract, rescission of a capital increase invalidates the capital increase, rescission of an amendment to the articles removes the amendment etc. The reason behind this proprietary remedy is twofold:

- removing the decision completely is considered to be a most effective way of compensating the harm caused by it;
- as for decisions that concern a transaction with a third party, the proprietary effect of rescission suits mimics the proprietary remedies that creditors have under general civil law, especially the so-called *actio pauliana*, that allows creditors to strike out transactions between their debtor and a third party that fraudulently harm their interests. The fact that shareholders

are, legally speaking, no creditors, yet have a significant interest in the company's wellbeing, explains the need for such mimic.

Secondly – and this is where continental company law is special – derivative actions cannot produce a similar proprietary remedy on itself. Derivative actions are tied to director liability rules. They are brought against directors personally, and remedies are purely compensatory: the directors that are held liable have to compensate the loss the company is inflicted with, which is mostly done by paying damages. Under UK company law, on the contrary, a successful derivative action against directors can result in a transaction between the company and another person being rescinded[2].

The advantages of the proprietary remedy following a (successful) rescission suit over a derivative action are evident:

- it encompasses a vigorous possibility to interfere with company transactions;
- its success does not depend on the identification of one or more wrongdoers amongst the directors, but rather on the identification of a wrong committed during the decision-making process;
- the restorative capacity of its outcome is not subordinate to a risk of insolvent directors.

4. Remedy for reflective harm. The proprietary character of (successful) rescission suits thus explains both how they contribute to reducing agency costs and why they exist in addition to derivative actions. In fact, as rescission suits contribute to reducing agency costs, they are aimed at restoring harm the company has been afflicted with, namely (formal or substantive) deficiencies in the company's decision-making process that need be restored to avoid excessive agency costs. That means that when a shareholder is allowed to file a rescission suit, he in fact sues to restore company harm, not personal harm[3]. In such a way, he is suing for the recovery of reflective harm, i.e. harm he is afflicted with only through reflection of harm done to the company. Rescission suits are in itself just another kind of derivative litigation, yet with a proprietary remedy attached to it. They exist in addition to derivative (liability) actions, that cannot provide a similar proprietary effect, as said in no. 3.

5. Considerably lower thresholds. There is one more thing to be added. The fact that rescission suits and derivative (liability) actions exist as separate procedures, has allowed legislators to treat them differently as regards standing to sue. The thresholds to bring a rescission suit, moreover, appear to be considerably lower than those applicable to derivative (liability) actions, as the table below indeed shows.

As a general principle, company law prohibits shareholders to personally sue for company harm, as the proper plaintiff in that respect is the company, and the company alone (through its standard decision-making bodies). The rationale therefore is mainly twofold. First, it prevents double recovery when the

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[2] See Explanatory Notes (Part 10, Chapter 2 CA 2006) no. 322.

[3] This is evidence most clearly by formal deficiencies, such as deficient convocation of a meeting, exclusion of a member, etc. In the countries studied, such formal defects only lead to rescission of the decision if the claimant subsequently proves that the formal deficiency has influenced the decision the company has made. In other words: proof of purely personal harm does not suffice.

company also sues. Secondly, allowing shareholders to personally litigate for corporate harm would enable them to remove assets from the company, to the potential detriment of company creditors. Jurisdictions have tried to balance the aforementioned prohibition and the concern to install sufficient control on company governance through (the threat of) enforcement actions by shareholders, in order to reduce agency costs. The result of that balance is the existence of derivative (or 'minority') actions: when successful, judgement is delivered in favour of the company, without direct personal benefit for the claimant. These actions are in most of continental Europe available for shareholders upon reaching a certain threshold, which is designed to thwart a flood of claims. Rescission suits, whilst also being 'derivative' litigation, are usually linked to lower thresholds or even no real threshold at all. The following table gives an overview.

Country	*Rescission suit threshold*	*Derivative (liability) action*
Austria	1 share[4]	10% of legal capital[5]
Belgium	1 share[6]	1% of voting rights or EUR 1.250.000 of share capital, for public limited companies[7] 10% of voting rights, for private limited companies[8]
France	1 share (however not explicitly stated in the law)	1 share[9] *or* 5% of voting rights, in listed companies (threshold diminishes progressively once legal capital is over EUR 750.000)[10]
Germany	1 share[11]. As for board decisions: 1 share, yet only insofar the decision substantially interferes with the shareholder franchise[12]	1% of issued share capital or a fractional amount of at least EUR 100.000[13]
Italy	0.1% of share capital, for listed companies 5% of share capital, for non-listed companies[14] As for board decisions, there is some debate as to whether the aforementioned thresholds are applicable as well[15], or that a shareholder can sue *ut singuli* on the condition that only personal rights have been infringed[16].	2.5% of share capital, for listed companies[17] 20% of share capital, for non-listed companies[18]
Luxemburg	1 share (however not explicitly stated in the law)	Not available
the Netherlands	*General rescission suit regime*: 1 share[19] *Inquiry proceeding*: 10% of the outstanding shares or giving right to shares with a nominal value of	Not available

[4] § 196 AktG.
[5] § 134 (1) AktG.
[6] Art. 178 Companies Code.
[7] Art. 562 Companies Code.
[8] Art. 290 Companies Code.
[9] Art. L 225-252 Code de Commerce.
[10] Art. L 225-120 Code de Commerce.
[11] § 245 AktG.
[12] BGH 25 February 1982, BGHZ 83, 122, *Holzmüller*.
[13] § 148 AktG.
[14] Art. 2377 (3) Codice Civile.
[15] as could be inferred from a literal reading of art. 2388 (4), that refers to general meeting decisions.
[16] which is, in fact, a perspective similar to German law.
[17] Art. 2393*bis* (2) Codice Civile.
[18] Art. 2393*bis* (1) Codice Civile.
[19] Art. 2:15 Civil Code.

	EUR 225.000 (when share capital exceeds 22.5)[20]	

Strikingly, German and – at least according to part of the literature – Italian company law are more severe in terms of standing towards board decisions in comparison with general meeting decisions. It is understandable to differentiate between both decisions from an opportunist perspective: board decisions perhaps tolerate less interference than general meeting decisions. However, strangely enough, in those two countries the difference in treatment is not explained by pragmatics, but by reference to the prohibition for shareholders to recover for reflective loss. That is remarkable for two reasons:

- it is not clear why an invalid general meeting decision would constitute any less company (and thus reflective) harm than a board decision. This myopia can be explained by again referring to the fact that derivative actions, in the countries studied, are tied to director liability rules. Potentially that gives the (wrong) impression that only directorial actions need be considered in light of the prohibition to recover for reflective loss;
- more importantly, a difference between both decisions cannot be justified by referring to the prohibition to recover for reflective loss, because the aforementioned rationale for not letting shareholders recover for reflective loss does not apply to rescission suits. The very proprietary nature of that remedy explains why. Given its proprietary nature:
    - rescission suits cannot lead to double recovery: the resulting rescission affects everyone involved, and not just the plaintiff (as would be the fact with awarding damages following a derivative liability action);
    - rescission suits cannot lead to a transfer of company assets to the plaintiff's own property: again, the resulting rescission affects everyone involved, so that there is no private benefit to be feared.

B. Third party protection as a limit to the function of rescission suits to reduce agency costs, in particular between shareholders and directors

6. The preceding paragraphs have explained why rescission suits exist in addition to derivative (liability) actions. It seems as if rescission suits provide shareholders with a broadly shaped enforcement tool, that they can more easily use than derivative actions. As far as standing is concerned, that is correct, at least for most of the studied countries. It then matters little, or a little less, that derivative actions are treated quite reluctantly on the continent. That statement, however, depends on the ability of rescission suits to actually reduce agency costs between shareholders and directors, given that derivative (liability) actions aim at reducing those agency costs.

In that respect, the following paragraphs will try to argue that the pursuit for third party protection impedes the effectiveness of rescission suits in reducing agency costs between shareholders and

[20] Art. 2:346 Civil Code.

directors, and thus limits the ability of such suits to act as a functionally equivalent mechanism to derivative actions.

7. Third party protection rules. As said previously, a successful rescission suit leads to the involved decision being declared null and void, which results in the removal of everything that has been done in implementing that decision. The very proprietary effect of rescission suits, of course, creates externalities. Whenever a person other than the company (a third party) gains rights on the basis of the involved decision or its implementation, the return to the *status quo ante* undoubtedly affects these rights: they disappear with the decision that created them, or, more precisely, the implementation of which created them. Generally speaking, third parties are protected against such horror. Their protection is organised in two ways.

On the one hand, third parties are protected through agency rules. According to these rules, that have been harmonised throughout Europe (First Company Law Directive 68/151/EEC), the power of a director to bind the company to persons dealing with the company in good faith, is deemed to be free of any restriction to that power under the company's articles of association, whether it be published or not. Such broad protection serves the interest of the company itself: if third parties in good faith could not ignore internal restrictions on the power of directors to bind the company, they would avoid dealing with companies in the first place. Companies would then be marginalised in the economy, although one mainly incorporates a company to engage with the economy. It then easily follows that, when internal restrictions under the company's articles can be ignored, the same goes for other internal deficiencies, such as an invalid(ated) decision. Whether that decision is judicially rescinded or not, the transaction between the company and the third party (in good faith) stands.

On the other hand, in the specific context of rescission suits there exists a solid consensus in the countries listed in the table in no. 5 to protect rights acquired by third parties in good faith[21]. That consensus stems from a period wherein agency rules were not as developed as they are now, in which it was necessary to provide for a specific rule as to rescission of company decisions. Nowadays, agency rules largely outshine them, albeit that they still provide useful services for filling protection gaps when agency rules are not applicable (e.g., (intermittent) distribution of profits, increase of (authorised) capital, share repurchase, etc.).

Furthermore, it is important to note that it will, in both cases, not be easy to rebut the presumption of good faith. Such an attempt generally requires that the third party has or ought to have knowledge of the cause to rescind the decision. When agency rules, as harmonised by the First Company Law Directive, apply, mere (actual or constructive) knowledge of the cause of rescission will even not suffice. The third party must also participate in the director's mischief, i.e. there must be some kind of collusion or conspiracy between the third party and the director.

[21] This consensus has even been crafted as a separate rule in some countries. See for Belgium: art. 180 Companies Code; for France: art. L 235-12 Code de Commerce; for Italy: art. 2377 (7) and 2388 (5) Codice Civile; and for the Netherlands: art. 2:16 Civil Code.

8. Board vs. general meeting. It is clear from the aforementioned that, when third party rights are involved, the effectiveness of rescission suits is restrained to cases of bad faith of the third party. In order to now substantiate the statement that this impediment formed by third party protection rules is more relevant to the reduction of agency costs between shareholders and directors than it is to the reduction of agency costs between minority and majority shareholders, we have to draw a distinction between board decisions and general meeting decisions.

As mentioned earlier, it is submitted that rescission suits against general meeting decisions address agency costs between minority and majority shareholders, while similar suits against board decisions aim at agency costs between shareholders and directors.

Rescission suits against general meeting decisions are devised to make sure that shareholder participation rights are respected, allowing a shareholder to cast his vote. Those rights counterbalance the fact that a general meeting does not decide unanimously, but according to (qualified) majority rule(s). Therefore it is vital for a shareholder to be able to challenge an unlawful exclusion, an unlawful restriction of participation rights (e.g., asking questions during the general meeting), or an abuse of the majority rule. As an enforcement mechanism, rescission suits thus help to keep balance between efficient decision-making, which requires majority rules, and minority shareholder protection.

As regards board decisions, shareholders of course have no participation rights. The purpose here is not to enforce participation, but to have indirect control over the necessary delegation of directorial power to a few, selected directors (see also no. 2). Rescission suits help shareholders to exercise such control; they help to reduce the costs of having to delegate decision-making power to a board of directors.

In searching to assess the statement whether rescission suits can be functionally equivalent to derivative actions, that aim to reduce agency costs between shareholders and directors, the focus thus is on whether rescission suits board decisions are particularly hindered by third party protection rules.

9. Board decisions. Board decisions will very rarely not touch upon rights of third parties. That is due to the fact that, besides the inside transactions for which the power (may) reside(s) in its competence (e.g., use of authorised capital, intermittent distribution of profits, etc.), the board is principally in charge of binding the company to third parties. The advantage of rescission suits against board decisions is therefore most of the time limited to cases in which third parties have not acted in good faith. As stated earlier, that is not easily provable. That does not mean that rescission suits do not contribute to lowering agency costs between shareholders and directors. But it does restrict such added-value to cases of bad faith.

Three nuances are possible, yet have to be refuted. First, third party protection only kicks in when rights have been acquired by a third party. Inversely: when a board decision has not yet been implemented, third party protection does not impose a limit to the purported remedy of a rescission suit. Although that is true, (minority) shareholders will not have sufficient information on what the board has decided. Very often, it will for them only be clear what exactly the board has decided, after a decision has been carried out.

Secondly, the limit imposed by third party protection does not restrict rescission suits against board decisions. It is still possible to bring such a suit. That means that they still might entail governance changes (e.g., dismissal, less remuneration, or ground for liability suits) or negative reputational consequences for the directors involved in the decision-making process. Such changes or effects might deter directors from wrongful decision-making, so that rescission suits still might contribute to reducing agency costs between shareholders and directors. However, there are several objections to be made:

- while it is true that a wrongful decision equals a fault for the directors involved, that does not automatically make them liable as such;
- furthermore, indirect deterrence is very hard to measure. The literature concerning derivative actions has to this day failed to support a general deterrence argument with convincing empirical evidence. It thus is quite hard to construe an argument for functional equivalence on the basis of deterrence alone.
- lastly, rescission suits are brought against the company, and not against directors personally. That means that excessive and costly litigation increases company harm, rather than restoring it. And more company harm equals more reflective loss for shareholders. Consequently, shareholders are disincentivised to excessively challenge board decisions if the purported remedy is not readily available.

Thirdly, the limit imposed by third party protection does not (in theory) oppose the possibility of rescinding the decision; it only dictates that the transaction between the company and a third party be unharmed. Theoretically, a board decision thus can be rescinded, obliging the board to decide again on the matter. However, if the rescission cannot affect the transactions made through implementation of the decision, there is little sense in having a board decision rescinded at all. No matter what decision the board will make after a first decision was rescinded, the company is still bound with respect to the rights that third parties have acquired on the basis of the first decision[22].

For board decisions, the conclusion is that rescission suits only provide for an effective remedy in cases where it will be possible for a shareholder to prove that the involved third party acted in bad faith. That rather restricts the value of such suits in reducing agency costs between shareholders and directors.

10. General meeting decisions. A similar argument as in no. 9 can be constructed with respect to general meeting decisions: when third party rights are in play (e.g., approval for outside transactions required under the articles, capital increase, distribution of profits, share repurchase etc.), it will be hard to suggest rescission suits provide for an easy remedy in mitigating agency costs in between

[22] That is the reason why it makes sense to go even further and restrict the possibility for shareholders to sue for rescission subject to the proof of bad faith. A similar position has already been adopted by the Dutch Supreme Court, that refuses to allow rescission suits when rescission cannot be of any help due to third party protection rules: HR 28 February 1992, *NJ* 1992, 458, note Ma; HR 19 May 1989, *NJ* 1989, 652.

minority and majority shareholders. However, several elements suggest that perhaps rescission suits perform better with regard to general meeting decisions.

First, as a shareholder participates at the general meeting – or at least has the chance to do so – he will be more and sooner acquainted with the substance of decisions made.

Secondly, general meeting decisions will more often deal with purely internal, organisational matters, such as ratifying annual accounts and reports, amending the articles of association, etc. In other words, a general meeting will less often deal with matters that directly interfere with third party rights.

Thirdly, it is much more costly to repeat the decision-making process at shareholder level, whether the involved decisions affect third party rights or not. Especially in larger companies, holding a general meeting is a costly affair. Having to redo the whole show, only increases those costs, both in terms of costs actually spent to the organisation of a meeting and the opportunity costs of the board that has to put its effort in that organisation. There is a bigger chance that, however doubtful a deterrence argument may be, rescission of a general meeting decision is considered to be more costly from an organisational perspective.

In contrast to board decisions, the total interference of rescission suits against general meeting decisions by third party protection rules will be less. Concordantly, the aim to reduce agency costs between minority and majority shareholders will be disturbed in lesser cases.

11. Why have rescission suits against board decisions at all? It would be rather short-sighted to conclude that rescission suits against board decisions serve no purpose, because their effective use is limited to cases in which third parties have acted in bad faith. Rescission suits still are a vigorous way for shareholders to reverse transactions – third party protection does not change that. In fact, the limit imposed by third party protection keeps rescission suits against board decisions in tune with the proprietary remedies in general civil law, for which they are meant to provide an alternative (see no. 3). These general civil law remedies are, generally speaking[23], available to any creditor who can prove his debtor transacted fraudulently with a third party, who was aware of the fraud (i.e. bad faith). Given that rescission suits, when directed at decisions that involve a transaction with a third party, are partially designed as an alternative to these civil law remedies (see, again, no. 3), it may not come as a surprise that such rescission suits are restricted along more or less the same lines. They give shareholders a right similar to creditor rights, but not without an equally similar constraint to prove bad faith.

12. Conclusion. This paper can be summarised as follows. The proprietary remedy following a (successful) rescission suit explains both how they contribute to reducing agency costs and why they exist in addition to derivative actions. As a(nother) remedy for the restoration of company harm, rescission suits provide a functionally equivalent enforcement mechanism to derivative actions.

[23] Gratuitous legal acts are usually exempt from creditors having to prove bad faith.

To the benefit of third parties acting in good faith, continental European company law sees to it that their rights are left unharmed by the proprietary remedy that follows upon a successful rescission suit. That bar to rescission affects rescission suits against board decisions substantially more than suits against general meeting decisions. Therefore, it is submitted that while rescission rules are designed to reduce agency costs, their ability to mitigate agency costs between shareholders and directors is considerably more restricted, as a consequence of third party protection rules, than their ability to control agency costs between minority and majority shareholders.

While in keeping with the proprietary remedies in general civil law, third party protection rules do limit the theoretical ability of rescission suits to be functionally equivalent to derivative actions. Consequently, they do not make up for the reluctant way in which derivative actions are treated. Further research is needed in order to improve derivative litigation on the continent, in particular as regards standing thresholds and cost rules.

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